

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Thomson and Campbell Analyst: Kimberly Pantoja Bill Number: AB 39
Related Bills: See Legislative History Telephone: 845-4786 Introduced Date: 12/04/2000
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Employer Provided Health Insurance Premiums Refundable Credit

SUMMARY

This bill would create a refundable tax credit to an employer for providing health coverage for certain employees and their dependents.

EFFECTIVE DATE

As a tax levy, this bill would be effective upon enactment. However, this bill specifies that it would be operative for taxable years beginning on or after January 1, 2002.

LEGISLATIVE HISTORY

AB 1734 (2000), which also proposed an employer provided health insurance premiums refundable credit, failed passage in Assembly Appropriations.

AB 1262 (1999/2000), which proposed an employer provided health care coverage credit, failed passage due to missing the deadline for passing out of the house of origin.

AB 1172 (1999), AB 2520 (1998), and AB 148 (1997) each proposed an employer provided health care credit for farmworkers, and each failed passage in policy committee.

SPECIFIC FINDINGS

Under federal law, to which California conforms, an employer's contribution to an accident or health plan for the benefit of the employee or the employee's spouse or dependents is not includable in the employee's gross income.

Existing federal and state laws allow ordinary and necessary business expenses to be deducted, which would include health care coverage premiums paid by an employer for accident or health plans for employees.

Existing federal and state laws allow self-employed persons to deduct from gross income 60% of amounts paid during 2000 for health insurance for themselves, spouses, and dependents. The self-employed health insurance deduction remains at 60% through 2001. It then increases to 70% in 2002 and 100% in 2003 and thereafter.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Gerald H. Goldberg

02/16/01

Existing state and federal laws provide various tax credits that are designed to provide tax relief for taxpayers who incur certain expenses (e.g., child and dependent care credit) or to influence behavior, including business practices and decisions (e.g., research credits).

Current federal and state laws do not provide tax credits for any health care costs. Prior **state law** would have provided a small-employer health coverage tax credit (SB 2260, Ch. 1521, Stats. 1988). However, that credit was repealed before ever becoming operative.

This bill would provide a refundable credit for amounts paid or incurred during the taxable year by an eligible employer (including a self-employed individual) to provide health coverage for an eligible individual and that individual's dependent or dependents. To qualify for the credit, an eligible employer must employ on the average during the year no more than 15 employees. Also, an eligible employer must pay or incur at least 75% of the monthly premium for health coverage for an eligible individual who elects to have that coverage and who does not pay more than 25%. The employer must make participation in health coverage available to all eligible individuals at least annually.

This bill defines several terms, including "eligible employer," "eligible individual," "health coverage," and "dependent." "Dependent" would include any individual insured by the eligible individual's plan contract or plan policy. The bill specifies in the definition of "eligible employer" that a self-employed individual's earned income must not exceed twice the state's minimum wage multiplied by 1,560.

This bill specifies the amount of the credit would be 50% of the total amount paid or incurred per month per eligible individual for that health coverage provided by the employer during the taxable year.

This bill specifies that no deduction would be allowed for the same amounts for which the credit was allowed.

This bill specifies that any credit in excess of the taxpayer's tax liability would first be credited against other amounts due, and the balance, upon appropriation by the Legislature, would be refunded to the taxpayer.

This bill specifies the Department of Corporations must forward to the Franchise Tax Board (FTB) upon request a list of all health care service plans that provide coverage for basic health care services and are licensed under Chapter 2.2 of the Health and Safety Code. The Department of Insurance must forward to FTB upon request a list of disability insurers that provide coverage for hospital, medical, or surgical expenses and that are authorized to transact disability insurance in this state.

Policy Considerations

Historically, refundable credits (such as the prior state renter's credit and the federal Earned Income Credit) have had significant problems with invalid and fraudulent returns. These problems are aggravated because a refund that is later determined to be fraudulent commonly cannot be recovered. However, fraud concerns are somewhat reduced with this credit due to narrow criteria when claiming the credit and the fact that the department will have a list of health care services and plans for use in auditing.

This credit would be determined on an "employee-by-employee" basis. It appears that the intent is to require self-employed people to pay for coverage for both themselves and their employees. However, it would be possible for an employer to offer participation without paying for coverage for the employees but still claim the credit for their own coverage. If this is not the author's intent, clarification is needed in the bill.

This bill does not specify a repeal date. Credits typically are enacted with a repeal date to allow the Legislature to review the effectiveness of the credit.

Implementation Considerations

The department has never administered a refundable tax credit under the Bank and Corporation Tax Law (B&CTL). Establishing a refundable tax credit program would have a significant impact on the department's programs and operations and require extensive changes to forms and systems.

This bill does not modify the hierarchy of B&CTL tax credits (Section 23036), thus the order in which credits would be applied before this credit would be refunded is unclear. The existing hierarchy of tax credits under the Personal Income Tax Law (PITL) includes refundable credits (Section 17039). Amendment 13 has been provided to resolve this consideration.

This bill specifies that in order for an employer to qualify for this credit, participation in a health plan must be made available to all eligible individuals at least annually. The FTB has no practical way to verify that the employer has fulfilled this requirement.

This bill would require an appropriation by the Legislature to pay for this credit. Disallowance of the credit to some taxpayers could result if the amount of credits claimed exceeds the funds appropriated. If sufficient funds are not appropriated to cover all of the refunds due, interest would have to be paid to refund recipients. Additional contact to the department by refund recipients would likely increase departmental costs.

The bill's definition of "dependent" is not consistent with the definition provided in the Internal Revenue Code (IRC), which is used for state tax purposes. This could be confusing for taxpayers since the premiums for health care coverage paid by an employer for individuals other than an employee's dependents, as defined in the IRC, are not excluded from gross income. Amendments 10 and 23 have been provided to resolve this concern.

Since the proposed credit is refundable, the credit calculation would need to be shown on the PIT return. This would increase the PIT return by one-page, which would result in a significant impact on FTB's operations and costs. Adding a page to the PIT return may require FTB to lease additional office space and file storage space, although the department would work within available space to the extent possible. Costing for additional space has not been determined at this time and is not included in the department's administrative cost estimate.

The bill limits the credit to the cost of health care coverage provided to an employee who works for an average of at least 30 hours per week. However, it does not specify the period for which the average hours worked is to be determined. The bill also allows the credit for the cost of health care coverage provided to an employee who works less than 30 hours per week.

This suggests that the intent is to allow the credit during any period that health coverage is provided, regardless of the number of hours an employee works.

The bill specifies that an eligible employer must not employ more than 15 employees and provides a calculation to establish the average number of employees. The calculation is based on a 30-hour week and would eliminate employers with 12 or more employees. The authors' staff has indicated that this is not the intent and will amend the bill accordingly.

Technical Considerations

This bill requires the employer to pay at least 75% of the monthly premium for the individual or individual's dependent or dependents to be eligible for the credit. However, only the language on dependents (subdivision (c)) makes reference to when two or more eligible employers share in the expenses, leaving it unclear whether the 75% requirement applies when two or more employers share in the costs for an individual (subdivision (b)). Also, if several taxpayers share costs but none individually pays at least 75%, the possibility exists that there would be no "eligible" taxpayers. The language needs modification to ensure that the authors' intent is achieved.

Amendments 1 and 16 are provided to clarify that only the direct costs of health care coverage are included and not the indirect costs associated with administering an employer's health care program for employees.

Amendments 6 and 8 are provided to clarify that self-employed individuals must have earned income sourced in California.

The definition for "eligible individual" in the PITL section appears to require both that the individual be an employee (subparagraph (A)) and a self-employed individual (subparagraph (B)). Amendment 7 has been provided to reflect that "either" (A) or (B) is required to be met.

Amendments 9 and 21 are suggested to clarify the definition of "health coverage."

Amendments 2 and 17 are provided to require the taxpayer to retain records to substantiate the credit claimed.

Amendments 12 and 25 are provided to correct the reference from "Department of Corporations" to "Department of Managed Health Care."

Amendments 3, 4, 5, 11, 14, 18, 19, 20, and 24 are provided to renumber subdivisions.

Amendments 15 and 22 are provided to make nonsubstantive technical changes.

FISCAL IMPACT

Departmental Costs

First year implementation costs are estimated to be \$1.8 million and ongoing costs are estimated to be \$1.2 million per year. It is estimated that this bill would require the department to incur 37 additional personnel years (PYs) in the first year of implementation and 31 PYs in the ongoing years. Due to an operative date of January 1, 2002, funds will be requested through the budget change proposal process to cover these departmental costs.

The estimated costs are associated with the printing and processing of the additional page to each return, changes to the computer systems, increased taxpayer telephone calls and correspondence, and electronic and paper storage.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in revenue losses beginning in 2001-02 as follows.

Estimated Revenue Impact of AB 39 As Introduced 12/4/00 [\$ In Millions]		
2001-02	2002-03	2003-04
-\$80	-\$970	-\$1,050

The author's staff has indicated that the intent is to target firms with 15 or fewer employees who work 30 or more hours per week. The revenue analysis assumes the author's intent as indicated.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The number of eligible employers that pay at least 75% of health insurance premiums for eligible individuals and the number of eligible individuals would determine the revenue impact of this bill. The credit would extend to employers that already provide insurance as well as employers that commence coverage.

A summary of the methodology follows. Sources of data and other information used in developing this estimate include the Employment Development Department, Bureau of Labor Statistics, Small Business Administration, and independent surveys of employers. Employment data was the starting point. Employment data were adjusted to eliminate those employed by tax-exempt organizations and any ineligible employers, and to reflect annual growth. In 2002, eligible employers (firms with 15 or fewer employees who work 30-hours or more a week) will employ approximately two and a half million individuals.

A survey of employers released in early 1999, indicates 41% of employers (firm sizes of three to nine employees) and 62% (firm sizes 10 to 50 employees) currently offer health benefits. It is estimated that coverage drops from 62% to 50% for firms with 10 to 15 employees. Data indicate that even when a firm offers health benefits, not all workers are covered.

Approximately 60% are assumed actually covered for firm sizes of up to nine employees and 67% of up to 15 employees. Relevant percentages were applied to estimate the number of individuals currently insured by eligible employers.

Employers that currently provide insurance for eligible employees would forego expense deductions for insurance premiums. Under current law, the tax benefit of these deductions would be on the order of \$80 million for the 2002 taxable year.

An incentive effect for expanded health coverage was applied to derive the number of uninsured who become insured under the proposal. Applying the applicable incentive percentage for each year projected the incremental number of individuals that become insured (coverage assumed effective at mid-year).

Netting revenue losses estimated for the proposed credit with gains from foregone expense deductions derived liability year estimates. Liability year estimates were converted to the cash flow estimates above.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 39
As Introduced December 4, 2000

AMENDMENT 1

On page 3, strike lines 1 and 2 and insert:

for health coverage provided to an eligible individual for that individual and that individual's dependent or dependents.

AMENDMENT 2

On page 3, between lines 31 and 32 insert:

(d) The taxpayer shall retain records regarding the type of health care coverage provided and the amounts paid or incurred for that health care coverage and provide those records to the Franchise Tax Board upon request.

AMENDMENT 3

On page 3, line 32, strike "(d)" and insert:

(e)

AMENDMENT 4

On page 3, line 35, strike "(e)" and insert:

(f)

AMENDMENT 5

On page 3, line 40, strike "(f)" and insert:

(g)

AMENDMENT 6

On page 4, line 11, after "Code," insert:

in California

AMENDMENT 7

On page 4, line 16, after "who" insert:

satisfies either of the following criteria

AMENDMENT 8

On page 4, strike lines 27 and 28 and insert:

(B) Is a self-employed individual within the meaning of Section 401(c)(1)(B) of the Internal Revenue Code (relating to self-employed individuals) who has earned income from self-employment (within the meaning of Section 401(c)(2) of the Internal Revenue Code, relating to earned income) in California.

AMENDMENT 9

On page 4, strike lines 29 through 36 and insert:

(3) "Health coverage" means a plan, insurance policy, contract, or similar arrangement that is either:

(A) A health care service plan, as defined under subdivision (f) of Section 1345 of the Health and Safety Code that, at a minimum, provides coverage for basic health care services, as defined in subdivision (b) of Section 1345 of the Health and Safety Code, and is licensed pursuant to Section 1353 of the Health and Safety Code.

(B) A disability insurance policy that is issued by a licensed insurer in accordance with the California Insurance Code that, at a minimum, covers hospital, medical, or surgical expenses as provided in Part 2 of Division 2 of the California Insurance Code.

AMENDMENT 10

On page 4, strike lines 37 and 38 and insert:

(4) "Dependent" means a dependent, as defined in Section 17056.

AMENDMENT 11

On page 4, line 39, strike "(g)" and insert:

(h)

AMENDMENT 12

On page 4, line 39, strike "Department of Corporations" and insert:

Department of Managed Health Care

AMENDMENT 13

On page 5, between lines 7 and 8 insert:

SEC. 4 Section 23036 of the Revenue and Taxation Code is amended to read:

23036. (a)(1) The term "tax" includes any of the following:

- (A) The tax imposed under Chapter 2 (commencing with Section 23101).
- (B) The tax imposed under Chapter 3 (commencing with Section 23501).
- (C) The tax on unrelated business taxable income, imposed under Section 23731.
- (D) The tax on S corporations imposed under Section 23802.

(2) The term "tax" does not include any amount imposed under paragraph (1) of subdivision (e) of Section 24667 or paragraph (2) of subdivision (f) of Section 24667.

(b) For purposes of Article 5 (commencing with Section 18661) of Chapter 2, Article 3 (commencing with Section 19031) of Chapter 4, Article 6 (commencing with Section 19101) of Chapter 4, and Chapter 7 (commencing with Section 19501) of Part 10.2, and for purposes of Sections 18601, 19001, and 19005, the term "tax" shall also include all of the following:

(1) The tax on limited partnerships, imposed under Section 17935 or Section 23081, the tax on limited liability companies, imposed under Section 17941 or Section 23091, and the tax on registered limited liability partnerships and foreign limited liability partnerships imposed under Section 17948 or Section 23097.

(2) The alternative minimum tax imposed under Chapter 2.5 (commencing with Section 23400).

(3) The tax on built-in gains of S corporations, imposed under Section 23809.

(4) The tax on excess passive investment income of S corporations, imposed under Section 23811.

(c) Notwithstanding any other provision of this part, credits shall be allowed against the "tax" in the following order:

(1) Credits that do not contain carryover or refundable provisions.

(2) Credits that, when the credit exceeds the "tax," allow the excess to be carried over to offset the "tax" in succeeding taxable years, but do not contain refundable provisions. The order of credits within this paragraph shall be determined by the Franchise Tax Board.

(3) Credits that contain both carryover and refundable provisions.

(4) The minimum tax credit allowed by Section 23453.

~~(4)~~ (5) Credits for taxes withheld under Section 18662.

(6) Credits that contain refundable provisions but do not contain carryover provisions.

@@@@@@ Leg Counsel: Insert subdivisions (d) through (i) @@@@@@@@

AMENDMENT 14

On page 5, line 8, strike "SEC. 4" and insert:

SEC. 5

AMENDMENT 15

On page 5, line 14, after "employer" strike "to" and insert:

for

AMENDMENT 16

On page 5, strike lines 15 and 16 and insert:

health coverage provided to an eligible individual for that individual and that individual's dependent or dependents.

AMENDMENT 17

On page 6, between lines 5 and 6 insert:

(d) The taxpayer shall retain records regarding the type of health care coverage provided and the amounts paid or incurred for that health care coverage and provide those records to the Franchise Tax Board upon request.

AMENDMENT 18

On page 6, line 6, strike "(d)" and insert:

(e)

AMENDMENT 19

On page 6, line 9, strike "(e)" and insert:

(f)

AMENDMENT 20

On page 6, line 14, strike "(f)" and insert:

(g)

AMENDMENT 21

On page 6, strike lines 37 through 40 and insert:

(3) "Health coverage" means a plan, insurance policy, contract, or similar arrangement that is either:

(A) A health care service plan, as defined under subdivision (f) of Section 1345 of the Health and Safety Code that, at a minimum, provides coverage for basic health care services, as defined in subdivision (b) of Section 1345 of the

Health and Safety Code, and is licensed pursuant to Section 1353 of the Health and Safety Code.

(B) A disability insurance policy that is issued by a licensed insurer in accordance with the California Insurance Code that, at a minimum, covers hospital, medical, or surgical expenses as provided in Part 2 of Division 2 of the California Insurance Code.

AMENDMENT 22

On page 7, strike lines 1 through 4 inclusive.

AMENDMENT 23

On page 7, strike lines 5 and 6 and insert:

(4) "Dependent" means a dependent, as defined in Section 17056.

AMENDMENT 24

On page 7, line 7, strike "(g)" and insert:

(h)

AMENDMENT 25

On page 7, line 7, strike "Department of Corporations" and insert:

Department of Managed Health Care